A Proposal to Reform General Taxation in Montana

Positions and Recommendations
Submitted to the June Special Session
of the 51st Legislature

June 1989

Stan Stephens, Governor

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Contents

I. INTRODUCTION

I submit the following general tax reform and pension taxation reform proposals to the Legislature for consideration in the June special session. In the near future I will submit a separate proposal to address reduction of Montana's excessive personal property taxes.

I am convinced that the people of Montana want income and property tax relief and that a long term solution to the school equalization decision requires a new source of public school revenue. Therefore, I propose a general tax reform package to address these needed and desirable changes in our tax structure.

The recent U.S. Supreme Court decision mandates changes in our system of taxing retirement income. Section III provides a fair and equitable proposal in response to that decision.

II. GENERAL TAX REFORM

In my talks with Montanans over the past months, several themes have emerged among those calling for tax reform

- Montanans do not want additional taxes added to their present total tax load.
- Most Montanans would welcome less reliance on state and local property taxes for the support of K-12 schools.
- Income tax levels are considered burdensome by taxpayers in all income categories. These taxes have increased dramatically in the last few years due to changes in federal tax laws, and it would be counterproductive to further increase income tax burdens in Montana.
- Our top marginal tax brackets (10 and 11%) and our punitive treatment of investment income (capital gains) add to our poor image as a place to invest, work and do business.
- Any state sales tax should contain provisions to mitigate its impact on low income Montanans.
- Postsecondary education, especially the university system, must remain competitive and must play a large role in the economic development of the state.

In response to the above observations, I am proposing a 3% state general sales tax on goods with the bulk of the revenue committed to reducing and replacing property and income taxes. Services and basic necessities — food and medicine — would be exempt from the tax. The net revenue for allocation would be $202 million (total $206 million less $4 million administration funding) per year (FY 92).

We propose the following allocation of the sales tax revenue:

- <u>Provide Additional School Equalization Revenue</u> — To enhance the level of equalized state support for our K-12 school system, $120 million per year is proposed for the state school foundation program. With reasonable but fiscally prudent caps placed on the spending levels permitted in our K-12 schools, most of the $120 million commitment of sales tax revenue to school funds will result in dollar-for-dollar reductions in local school property taxes.
- <u>Reduce Residential Property Taxes</u> — To provide focused and additional reductions in residential property taxes, a homestead exemption of $15,000 is proposed ($15,000 will be subtracted from the assessed value of each home before it is subject to taxation). This will reduce residential property taxes in Montana by $25 million per year and amount to a $175 tax reduction on a home in a 300 mill taxing jurisdiction.
- <u>Provide Revenue for Income Tax Reform</u> — A $35 million package (see Figure 1) of income tax reform and reductions is proposed, with $19 million allocated primarily for elimination or substantial reduction of the income tax burden of low and modest income taxpayers. A higher and more reasonable state standard deduction allowance and other bracket changes will remove about 60,000 low income Montana households from the income tax roles. This makes it advantageous for a comparable number of additional households to switch from the more complicated and lengthy itemized tax return to the simpler standard deduction filing (see Appendix A for details).

  The 10 and 11% Montana income tax brackets, presently among the highest in the nation, would be eliminated. This reduces revenues by an estimated $6 million per year but will send a clear signal that Montana welcomes and fairly taxes new investment, entrepreneurs and enterprise.

  The income tax reform package extends our proposed pension exemption for federal, state and private pensions to include dividend and interest income for those over 62 years of age (see Section III for explanation of the basic retirement reform proposal). The cost is $4 million per year, but this plan will grant the same exemption to all forms of retirement income.

  To round out our income tax reform package, we propose changes in the taxation of capital gain income by removing the punitive tax on the artificial inflationary component and fully taxing the real gain.

FIGURE 1

Income Tax Reform

	Figures in Millions
Eliminate 10% and 11% Brackets	$ 6
Capital Gains Reform	6
Pension Taxation Reform	4
Eliminate 60,000 Low Income Households from Income Tax Rolls	19
Total	$35

As shown in Figure 2, approximately 85% of Montanans will experience income tax relief under my proposal. An estimated 14% will experience no change in their state income tax, while about 1% will experience minor tax increases due to changes in the income tax brackets.

FIGURE 2

Income Tax Reform Impact on Households

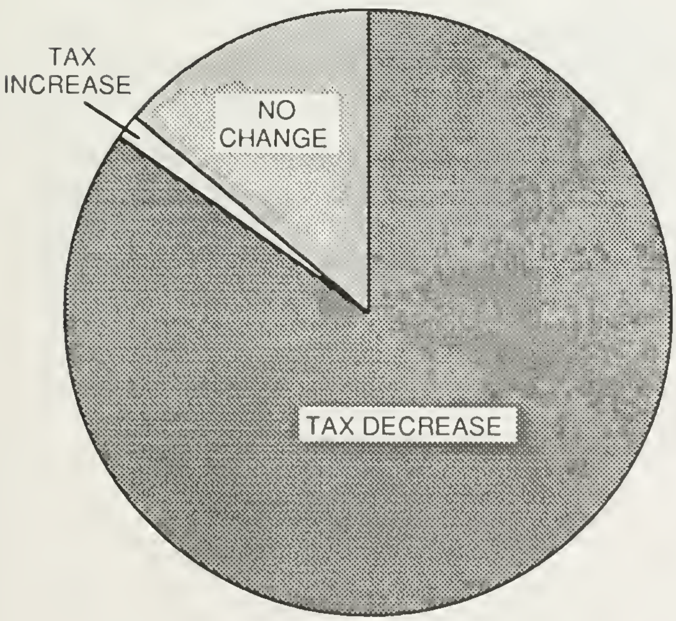
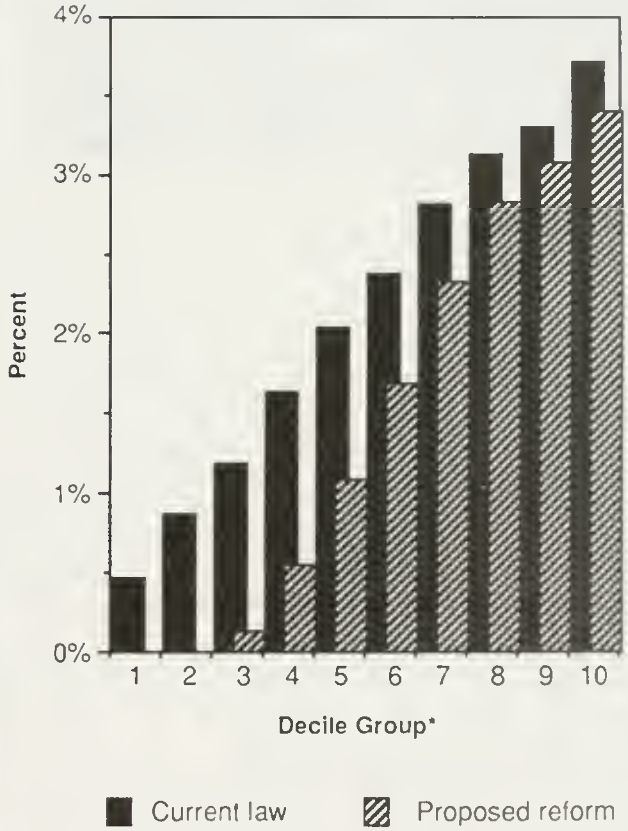


Figure 3 provides an indication of which income groups are estimated to receive income tax relief under the proposal. As indicated by the chart, the largest percentage reductions are enjoyed by low and moderate income households. On the average, state income taxes are eliminated for the lowest 20% of Montana taxpayers.

FIGURE 3

Income Tax Reform Comparison of Average Tax Rates

(Including Impact of Federal Tax)



* The numbers 1-10 refer to each 10% of taxpayers beginning with the lowest paying taxpayers.

Figure 4 summarizes our proposed allocation of the sales tax revenue.

FIGURE 4

Proposed Sales Tax Allocation

	Figures in Millions		
School Equalization	$120	Total	
Homestead Tax Relief	25	Tax	= $180 M
Income Tax Reform	35	Relief	
University System	16		
Education Reform	6		
Administration	4		
Total Collections	$206 million		

As shown in the table, the bulk of the new sales tax revenue is earmarked for reductions in other taxes. About $180 million of the projected net collections of $202 million is used for tax relief. The remainder is directed to increased support for postsecondary education. This is necessary if we are to maintain a competitive, strong university system which can lead the state's economy and our young people into the next century.

We believe this is a needed tax reform package which provides the revenue for the income and property tax relief sought by our residents. It does not result in an increase in the size of Montana government. The major beneficiary of any new revenue is the state's education system.

To further ensure that our proposal does not result in unwanted growth in government spending, we believe a constitutional referendum or initiative limiting the growth rate of total state spending is desirable. We are proposing such a referendum as a companion to the general tax reform package.

The people of Montana will not accept a sales tax used to increase the size of government. Our proposal reflects that belief.

III. REFORM OF PENSION TAXATION

In March 1989 the U.S. Supreme Court ruled that states may not discriminate between state public pensions and federal civil service pensions in its tax treatment (Davis v. State of Michigan). To comply with this Court ruling we propose a change in Montana's tax treatment of all pension income — state, federal and private — which treats all pensions in an equitable, non-discriminatory manner.

Approximately 12,000 Montanans presently are receiving pensions for past employment in public state jobs, and another 44,000 Montanans are actively employed and contributing toward such pensions. These workers were hired under the expectation that their pensions would be free of state taxation. These pension benefits were designed under this assumption, and until 1985 all such employees paid Montana income taxes on their contributions to their pension funds. These factors are taken into consideration in the design of a two-step pension exemption proposal.

STEP ONE

As a credit for previous taxes paid to Montana on employee contributions to any pension plan, a tax-free pension amount is given by formula:

Tax-Free Pension Credit =

35% of Pension —multiplied by— (Fraction of employment years contributions were taxed by Montana)

(This credit was calculated to allow an average employee to recover tax-free his previously taxed contributions, adjusted for inflation. Factors included in the derivation of the formula include an average worker's income stream, inflation rates, and the typical pension benefit formula.)

STEP TWO

An additional pension exemption is granted for all pensions — state, federal or private — equal to:

\$12,000 —multiplied by— Inflation Factor (defined in 15-30-101(8), MCA)

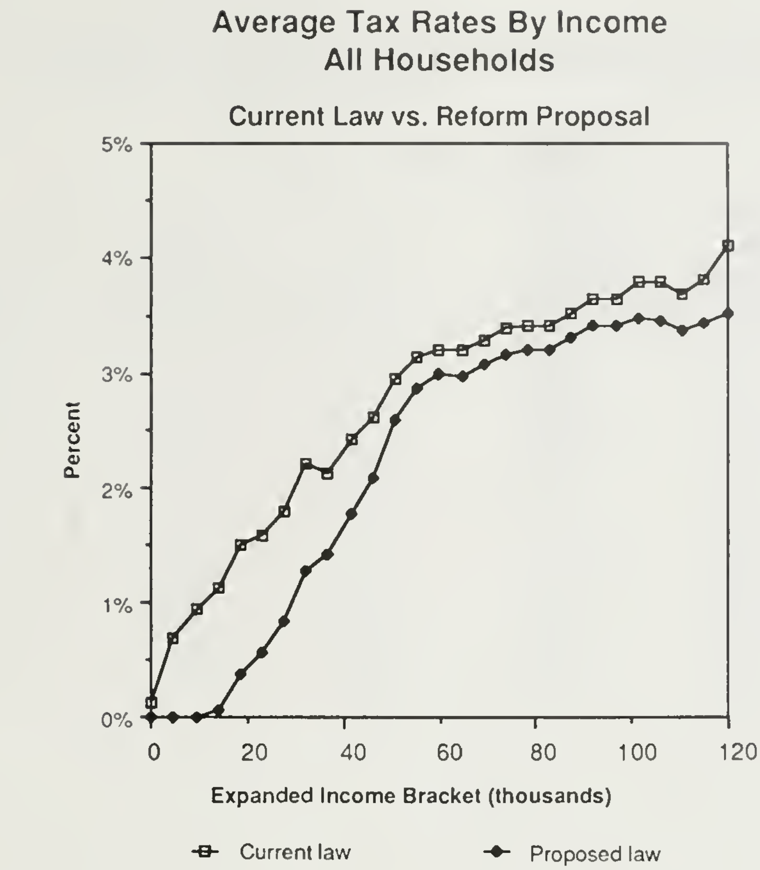
(The above allowance, with the inflation factor adjustment, equals about \$18,000 for the 1989 tax year and is tied to the cost of living for future years.)

To simply comply with the Davis decision will cost the state \$2.6 million annually. An additional \$1.4 million allows us to treat all pensions in a fair and equitable manner.

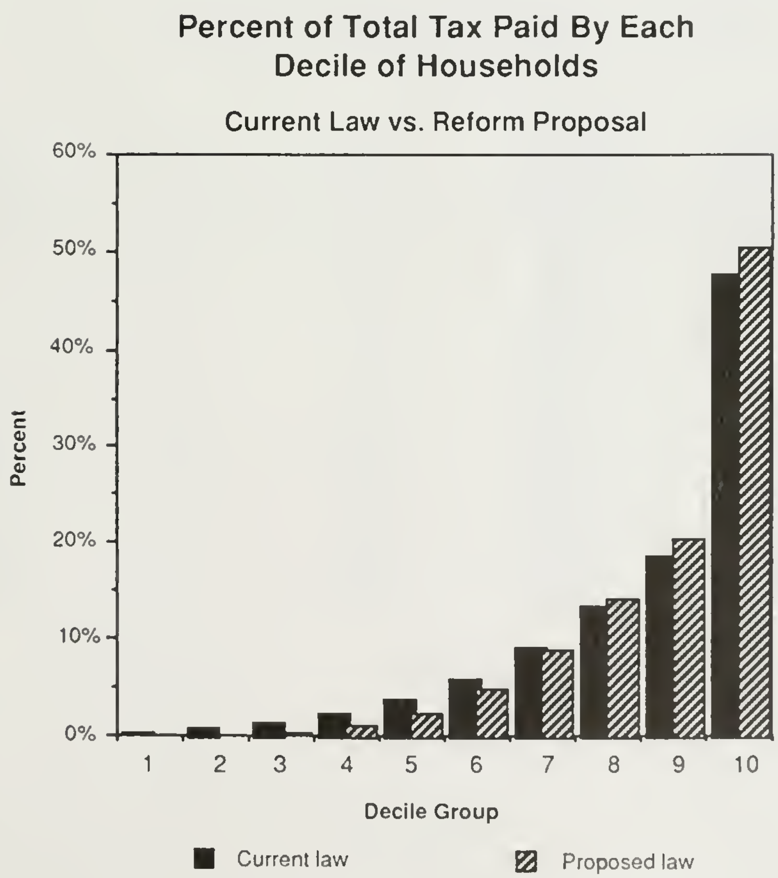
APPENDIX

Overview of Income Tax Reform Proposal

Provision	Current Law	Proposed Law
Standard Deduction (1989 Levels)	20% of MAGI up to $2,240 for singles, and $4,280 for joints and heads of households.	Flat amount of $2,990 for singles; $5,980 for married-joint and heads of households.
Personal Exemption (1989 Levels)	$1,190 per dependent, with an additional exemption allowed the elderly and the blind.	$1,490 per dependent, with an additional exemption allowed the elderly and the blind.
Capital Gains	40% exclusion of gains on sales prior to December 31, 1986. All other gains fully taxed.	Capital gains are indexed for inflation to allow only real portion of gain to be fully taxed.
Retirement	Private, federal, and public employees of other states allowed to exclude up to $3,600; benefits of state/local public employees fully exempt.	All retirees (state, federal, and private) allowed to exclude up to $18,000 of retirement benefits.
Changes in Tax Rates	Ten brackets with rates varying from 2% to 11% (2.2% to 12.1% with 10% surtax).	Three brackets with rates of 3%, 6%, and 9%.



Average Tax Rates By Income
All Households
Current Law vs. Reform Proposal
5%
4%
3%
2%
1%
0%
Percent
0
20
40
60
80
100
120
Expanded Income Bracket (thousands)
Current law
Proposed law



Percent of Total Tax Paid By Each
Decile of Households
Current Law vs. Reform Proposal
60%
50%
40%
30%
20%
10%
0%
Percent
1
2
3
4
5
6
7
8
9
10
Decile Group
Current law
Proposed law

Examples of Impact of Increased Standard Deduction

Single Taxpayer

Gross Income	Current Standard Deduction	Proposed Standard Deduction	Current Tax	Proposed Tax	Difference in Tax
$2,000	$ 400	$ 2,990	$ 8	$ 0	$ (8)
3,000	600	2,990	24	0	(24)
4,000	800	2,990	45	0	(45)
5,000	1,000	2,990	69	16	(53)
6,000	1,200	2,990	99	46	(53)
7,000	1,400	2,990	131	76	(55)
8,000	1,600	2,990	163	106	(57)
9,000	1,800	2,990	196	136	(60)
10,000	2,000	2,990	236	166	(70)
11,000	2,200	2,990	276	211	(65)
12,000	2,240	2,990	324	271	(53)
13,000	2,240	2,990	379	331	(48)

Married Couples with Two Children
Joint Return

Gross Income	Current Standard Deduction	Proposed Standard Deduction	Current Tax	Proposed Tax	Difference in Tax
$2,000	$ 400	$ 5,980	$ 0	$ 0	$ 0
3,000	600	5,980	0	0	0
4,000	800	5,980	0	0	0
5,000	1,000	5,980	0	0	0
6,000	1,200	5,980	1	0	(1)
7,000	1,400	5,980	16	0	(16)
8,000	1,600	5,980	34	0	(34)
9,000	1,800	5,980	58	0	(58)
10,000	2,000	5,980	85	0	(85)
11,000	2,200	5,980	117	0	(117)
12,000	2,400	5,980	149	2	(147)
13,000	2,600	5,980	181	32	(149)

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